OFFICE OF THE

ARIZONA STATE TREASURER

HON. DEAN MARTIN

TREASURER

May 12, 2010

To: Treasurer Dean Martin

From: Mark Swenson
Deputy Treasurer

Re: Update on State's cash balances, TWN needs and overall State Spending.

This memorandum is to update the State's fiscal condition now that the Legislative session has concluded with the Governor's final actions on all legislation sent to her.

GENERAL FUND DEFICIT

It appears the State's general fund will run a negative balance for the second consecutive year due to further revenue declines and lack of substantial budget reductions during the current fiscal year. (Please see spending section below.) Prior to the end of the legislative session, the Joint Legislative Budget Committee published an updated balance sheet that indicates a deficit of as much as $150 million for the current fiscal year. That compares to the estimated $450 million deficit that occurred in Fiscal Year 2009. So while there is improvement, it is unclear if deficits of this magnitude are allowed under Arizona's Constitution. As a note of interest, the audited Comprehensive Annual Financial Report for FY 2009 was just released and it places the general fund deficit at $978 million for June 30, 2009. I have asked the General Accounting Office for a crosswalk between the $978 million and the $450 million estimate from February 2010.

Our own internal forecast for the FY 2010 deficit is not as high as the JLBC estimate and currently pegs the revenue shortfall at about $85 million assuming no new revenue declines or increases in May and June. The good news is tax revenue for April 2010 was higher than April 2009 and through the first four months of the year, revenue is only down about 2.5% compared to the same time frame last year.

TREASURER WARRANT NOTE AND CASH FLOW UPDATE

As of Wednesday, May 12, 2010, we anticipate the need to issue about two dozen more Treasurer Warrant Notes for the current fiscal year until the Department of Administration closes the $750 million sale of the lottery and additional buildings in mid-June. The amount of TWN's issued has consistently tracked our forecast throughout the year. To date, the state has issued $86.5 billion in TWNS in FY 2010 at an average overnight interest rate of .93% and a cost of $3.5 million. We anticipate hearing back from Bank of America on the request to extend the TWN facility for FY2011 within the week. The delay in response has been due to the delay in receiving the audited Comprehensive Annual Financial Report, which was due from GAO on March 31, 2010 but released only yesterday.

Attached are the four forecast scenarios for TWN activity in FY 2011 based on the ballot outcomes of May 18, 2010 and Nov. 2, 2010. Under certain scenarios, namely the rejection of the ballot measures in November, it is possible that our office would not be able to convert TWNs into cash through the facility with B of A or from our internal investment funds.

At this point it does appear that we would not have to issue a TWN until sometime in late August or early September depending upon when the State Board of Education decides to pay the $950 million in deferred payments to school districts. Once we receive and evaluate B of A's response for the TWN extension for FY 2011, a meeting of the State Loan Commission to approve the terms is required prior to June 30, 2010. If the meeting is not held, or if the extension is not approved, then the facility will expire on June 30, 2010.

FY 2010 STATE SPENDING

I have reviewed all of the balance sheets produced by the JLBC for FY 2010 and would note that the final balance sheet lists on-going expenditures that are $11 million more than the original budget the Legislature sent to the Governor on June 30, 2009 while revenue forecast dropped by nearly $1 billion. The June 30, 2009 version anticipated ongoing revenues of $7.157 billion and ongoing spending of $9.669 billion, with the difference being made up with federal funds, borrowing, rollovers and fund sweeps. The governor vetoed portions of that budget and increased spending to $10.444 billion, which the Legislature followed up with a version that was signed by the Governor that increased spending even higher to $11.1 billion on July 6, 2009. The Legislature then produced a budget in August that spent $9.662 billion, which the Governor vetoed in part and increased spending to $9.932 billion. Subsequent budget cuts enacted in November, December, February and March brought spending down to $9.680 billion, about $11 million more in the aggregate from the June 30, 2009 version sent to the Governor. Revenue is now forecasted to be just $6.161 billion.

STATE SPENDING SINCE FY 2007

Finally, I have reviewed state spending for the past decade to determine how much in the aggregate ongoing state spending has been reduced. As you are aware ongoing state spending is the true measure of the state's ongoing liabilities and costs. The last budget that was not subject to mid-year reductions was FY 2007. This budget also was the last state budget that was free of all but one accounting gimmick to balance the budget. (That gimmick is the practice of requiring businesses to pay two months of tax receipts in June of each year.) To draw apples to apples comparison with FY 2011, I reduced spending in FY 2007 by $250 million to exclude the temporary repeal of the $250 million property tax that year as well as in fiscal years 2008 and 2009. (When the Governor vetoed the permanent repeal of the state tax, it reduced spending on the state's balance sheet by $250 million, but shifted that spending to taxpayers at the local school district level; therefore it is not a spending reduction, but a spending shift.) Most other state spending analysis reported to date has focused on budget reductions from the original FY 2008 budget. However, since that budget was never fully implemented, it is more accurate to examine what was spent in FY 2007 as the starting comparison point.

Therefore, examining the balance sheets produced by JLBC using these metrics demonstrates that overall spending for state agencies has decreased in the aggregate by only $207 million from its adjusted peak in FY 2009 of $9.716 billion to the proposed $9.509 billion in the FY 2011 enacted budget. Further, spending has actually increased $299 million from the adjusted FY 2007 based of $9.21 billion. One could argue that spending will go down another $400 million if the federal government fails to continue to pay a higher tab for Medicaid spending through June 30, 2011 and the state goes through with its planned elimination of services to 350,000 AHCCCS members. However, since the new health care funding bill requires the state to continue to serve this population or run the risk of losing all federal dollars for Medicaid, it is safe to assume that this spending will continue. Whether the Legislature and Governor cut spending elsewhere to make up the difference or raise revenues remains to be seen.

The lack of permanent reductions and solutions to the state's budget crisis was recently noted in the rating update issued last week by Moody's Investors Service. The rating agency maintained the negative outlook for Arizona based on a number of factors including, "reliance on non-recurring budget solutions causing significant structural budget imbalance."

While it is true that many state agencies have had their general fund budgets reduced dramatically during the past three years, the purpose of the reduction was to fund increases in the state's Medicaid program.

The just released 2009 CAFR illustrates this point on page 268 by showing that total enrollment in K-12 education has DECLINED about 20,000 students to 1,062,618 in FY 2009 from a count of 1,084,247 in FY 2007. Part of this drop was new federal rules prohibiting the state from double counting some students, which it had in the past. At the same time, enrollment in AHCCCS increased to 1,282,910 in FY 20009 from 1,065,444 in FY 2007. Further, page 267 shows that total state employment increased in FY2009 to 52,420.2 employees from 51,060.8 employees in FY2007.

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